

December 20, 2002

To: Supervisor Yvonne Brathwaite Burke, Chair
Supervisor Gloria Molina
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

From: David E. Janssen
Chief Administrative Officer

STATE LEGISLATIVE UPDATE

State Budget Update

\$34.8 Billion Budget Shortfall Background

Late Wednesday afternoon, the Davis Administration released the attached set of charts and tables as background information and detail to support the Governor's announcement that the Administration now projects the budget shortfall to be \$34.8 billion, some \$13.7 billion (65%) larger than the Legislative Analyst's (LAO) November estimate. This revision would ordinarily be a part of the Governor's January 10 budget proposal. Its announcement three weeks early suggests that the Governor is keeping pressure on the Legislature to act quickly in January on the first part of his proposed solution announced on December 6, some \$10.2 billion of spending reductions.

It should be noted that this is not an official forecast. The Governor once again urged that the LAO and Finance staff meet to try and reach agreement on a consensus forecast to avoid the potential problem of dueling forecasts. At this point the LAO is still scheduled to

redo their numbers as part of their February analysis of the Governor's January budget proposal. In the absence of a consensus forecast by the experts, the Governor indicated he would at least like to see the Administration and the Legislative Leadership agree on the numbers that determine the size of the problem that needs to be solved. Finally, while some have reacted to the size of the shortfall by suggesting a multi-year solution, the Governor indicated that he intends to propose a single-year solution.

Since the Administration did not provide an explanation or analysis of the charts, the following is our analysis of the attachments:

#1 The Pie Chart is a graphic, illustrating the general factors contributing to the \$34.8 billion shortfall. While the observation at the bottom notes that the shortfall equals 45% of the FY 2002-03 General Fund, it is important to keep in mind that the shortfall is a result of forecast revisions across three fiscal years, and may require more than one year to solve. In addition, the window of opportunity to address the problem is one and a half fiscal years, if the legislature begins to act in January.

#2 "Components of the Shortfall" contains additional detail on the three factors contributing to the shortfall. Over half the problem (51%) is attributed to "Loss of Revenue" which is a combination of less revenue than anticipated in the current and previous fiscal years (\$8.5 billion), and a downward revision in the projection for the budget year (\$9.2 billion). Almost 70% of the revenue loss is occurring in the personal income tax. The other major component at 36% - "Other Components" - are the one-time measures used to balance last year's budget that are not available in FY 2003-04.

One of the interesting things about these numbers is what they say about last year's budget solution which addressed a \$23.6 billion budget gap. Some \$10.4 billion of that solution has evaporated due to overestimates of revenue or underestimates of expenditures for FY 2002-03 and prior years. In reality, the adopted budget only amounted to a \$13.2 billion solution. In addition, \$12.6 billion of that solution were one-time measures, which did nothing to address the State budget's underlying structural problem. As a result, the size of the structural problem, which needs to be solved through permanent spending reductions or revenue increases, and which the LAO had estimated at around \$15 billion in their November report, is in fact larger - probably around \$24 billion.

#3 & 4 The graph (Attachment #3) claims to illustrate the dramatic drop in "wage" growth for relatively high earners (over \$100,000) who pay a major share of the State's progressive income tax. Since wages have not declined that dramatically, it probably includes non-wage compensation - capital gains, stock options - which have been in free-fall the last few years. It is the latter decline that is largely responsible for the deterioration in personal income tax revenues shown on the bar chart in "Attachment #4".

#5 This graph makes the point that all the major economic forecasts were wrong about the performance of the stock market in 2002, based upon Standard and Poor's Index of Value. All, including the LOA, projected increases when in fact the market declined 20% as measured by S&P. The expected conclusion is that no one anticipated the decline in capital gains/stock options and the resulting free-fall in personal income tax revenue.

#6 This bar chart on sales tax growth indicates that growth for the second largest source of State revenue has been negative for five of the last six quarters. If consumer spending is weak for the holiday season, the last quarter for 2002 will almost certainly be negative as well.

#7 The "Economic Forecast Comparisons" shows the changes and differences of opinion about some of the more important economic variables that underlie any revenue forecast. The May 2002 Revision contains the assumptions for the current budget. The LAO, November 2002, contains the assumptions underlying their recent estimate of a \$21.1 billion shortfall. The UCLA and U.S. Blue Chip are two December forecasts by respected, non-governmental forecasters. In arriving at the new, higher shortfall estimate of \$34.8 billion, the Administration seems to be relying heavily on the UCLA forecast assumptions. Of particular significance are the downward revisions in the projected growth of Gross Domestic Product (30%), and California Personal Income (45%) for 2003. The numbers suggest that the expected recovery in the economy has been postponed until 2004.

#8 The last table provides additional detail on the components of the \$17.7 billion revenue shortfall. Over two-thirds of the variance in FY 2002-03 and FY 2003-04 is in the personal income tax.

Assembly Budget Subcommittee Hearings

On Tuesday, December 17, 2002, the Assembly Budget Subcommittee on Health and Human Services held a hearing in Los Angeles on the Governor's proposed \$2 billion reduction in their area of the budget, as well as the proposed elimination of Stage 3 child care. The subcommittee heard from three panels of advocates and clients labeled: Adults, Elderly and the Disabled, Children and Families, and the Impact of Medi-Cal Cuts on Patient Care.

In their opening comments, most of the Democratic members indicated they would not vote for cuts unless they were part of a package that included revenue increases. Senator Cedillo reminded the audience that in the months before the November election

Californians were told to feel proud that their state had grown to become the fifth largest economy in the world but were now being asked to accept a third-world level of public services. Of the two Republican members present, Ray Haynes (R-Murrieta) repeated the standard line against no new taxes. However, Bob Pacheco (R-Walnut) indicated that he would approach the budget problem with an open mind and that, given the magnitude of the problem, the solution would need to be a balanced one. On a related note, Keith Richman (R-Northridge), in an interview on "Which Way L.A.", is reported to have said that he could vote for a tax increase if it were done in conjunction with a meaningful effort to reduce spending.

That same day the Assembly Budget Subcommittee on State Administration held a hearing in Sacramento on the Governor's proposals in their area of the budget. Issues of interest to the County included: the transfer of low and moderate income housing fund balances to the State, which the Community Development Commission/Housing Authority estimates would result in a \$800,000 loss; the deferral of payments of non-Proposition 98 state-mandated local costs which would be a \$45-50 billion loss for the County; a policy change that would make users responsible for 100% (currently 20%) of the costs of administering the workers compensation system which would increase the County's costs by \$1.7 million; and a proposed \$3.8 billion reduction in Public Safety Grants, some of which impact the Sheriff, the District Attorney and the Public Defender.

With respect to the housing fund transfer, members stressed the need to better define the term "unencumbered", given the differences of opinion on the total amount subject to transfer between the Administration and the LAO on the one hand and representatives of redevelopment authorities on the other. With respect to the deferral of mandate reimbursement, members indicated concern about how many years this could be done without causing local governments to cut services, and expressed interest in examining whether some mandates could be repealed or suspended. With respect to the shift to 100% user fees for the workers compensation system, one of the witnesses indicated that the current level of 20% was intended to be temporary when instituted in the 1980's and that 39 states and the District of Columbia financed their systems entirely through user fees. With respect to the Public Safety Grants, members asked that the Office of Criminal Justice Planning explain at a later time why some grants are cut or eliminated and others are unchanged. Finally, the subcommittee was told that the proposed \$470 million reduction in employee compensation costs would be the equivalent of a 9% salary reduction.

The Senate and Assembly legislative offices will be closed from Tuesday, December 24, 2002, through Friday, January 3, 2003. The legislature will convene on Monday, January 6, 2003.

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The CSAC building will be closed also during this same time, but the County's legislative office will remain open.

We will continue to keep you advised.

DEJ:GK
MAL:JR:ib

Attachments

c: Executive Officer, Board of Supervisors
 County Counsel
 Local 660
 All Department Heads
 Legislative Strategist
 Coalition of County Unions
 California Contract Cities Association
 Independent Cities Association
 League of California Cities
 City Managers Associations
 Buddy Program Participants